

FCC MAIL SECTION

Before the
Federal Communications Commission
Washington, D.C. 20554

DISPATCHED BY FCC Docket No. 93-50

In the Matter of

The Accounting and Ratemaking
Treatment for the Allowance for
Funds Used During Construction
(AFUDC)

NOTICE OF PROPOSED RULEMAKING

Adopted: March 2, 1993;

Released: March 22, 1993

Comment Date: May 13, 1993

Reply Comment Date: May 28, 1993

By the Commission:

I. INTRODUCTION

1. On January 11, 1991 the Ameritech Operating Companies (Ameritech) filed a Petition for Rulemaking requesting that the Commission modify its existing rule that requires carriers to use the compound prime rate of interest to calculate the Allowance for Funds Used During Construction (AFUDC). Ameritech proposes the use of the authorized rate of return instead of the prime rate.¹ A Public Notice was issued soliciting comment on the petition on February 15, 1991. Four parties favor initiating a rulemaking to consider the proposed modifications, and one party opposed.² After consideration of these filings, we propose to modify our Rules in Part 32, Uniform System of Accounts for Telecommunications Companies (USOA), and Part 65, Interstate Rate of Return Prescription Procedures and Methodologies, concerning AFUDC capitalization for both accounting and ratemaking purposes. In this Notice of Proposed Rulemaking (NPRM) we set forth a proposal to modify Parts 32 and 65 and seek comments thereon, as well as on alternative proposals.

¹ The prime rate is usually defined as the lowest rate of interest charged by a lender to its best customers for short-term unsecured loans.

² The parties that filed comments in favor are BellSouth Corporation, South Central Bell Telephone Company, and Southern Bell Telephone and Telegraph Company (BellSouth); New York Telephone Company, and New England Telephone and Telegraph Company (NYNEX); Southwestern Bell Telephone Company; and The United States Telephone Association. MCI Telecommunications Corporation (MCI) filed comments in

II. BACKGROUND

2. The issue before us is the proper accounting and ratemaking treatment for asset construction-related funds during the period before the assets are placed in service. For ratemaking purposes the Commission has recognized three general regulatory approaches to provide compensation to investors for the funds they provide for plant construction:

Capitalization Method. Exclude plant under construction from the rate base, but capitalize an allowance for interest on such plant under construction (i.e., AFUDC) by including it in the cost of construction. When plant is put into service, the cost of construction, including the capitalized AFUDC, is included in the rate base, and the AFUDC cost is recovered through depreciation.

Rate Base Method. Include plant under construction in the rate base and do not capitalize AFUDC.

Revenue Requirement Offset Method. Include plant under construction in the rate base and recognize AFUDC as part of the cost of construction. Since plant under construction is included in the rate base, the amount of AFUDC capitalized is included in income for ratemaking purposes, and, thereby, serves to offset the revenue requirement determination for the development of rates for services.

3. In 1967 in Docket 16258 the Commission required the Revenue Requirement Offset Method for ratemaking for AT&T and the Bell System companies.³ In 1977 in Docket 19129 the Commission concluded that long-term projects (projects under construction a year or longer) generally benefit only future ratepayers and found, therefore, that they should not be paid for by current ratepayers. Considering this, the Commission specified the Capitalization Method for compensating investors for the funds used for long-term construction. For short-term construction (projects under construction less than a year) the Commission decided that, because the duration of the construction period is relatively short and most current ratepayers will also be ratepayers when these construction projects are completed, it was neither practical nor necessary to distinguish between these current and future ratepayers. Accordingly, the Commission decided to specify the Rate Base Method for short-term construction.⁴ The approaches specified in Docket 19129 for ratemaking are still in effect today.

4. In the Docket 19129 proceeding the Commission also established the prime rate⁵ as the appropriate rate for accrual for AFUDC on long-term construction projects for AT&T and the Bell System. The Commission found that the Bell System companies at the time were being charged

opposition to initiating a rulemaking. NYNEX and MCI also filed reply comments.

³ American Telephone and Telegraph Co., *Interim Decision and Order*, 9 FCC 2d 30 (1967), *recon.*, 9 FCC 2d 960 (1967).

⁴ American Telephone and Telegraph Co., *Phase II Final Decision and Order*, 64 FCC 2d 1 (1977) (*Docket 19129*), *recon.*, 67 FCC 2d 1429 (1978).

⁵ The Commission specified that interest during construction be computed at a compounded annual rate that is based on a 13 month average of the prime rate. *Docket 19129* at 59.

the prime rate by financial institutions for their short-term debt and promissory notes and that nearly one-fourth of AT&T's construction budget could be funded by the short-term debt it carried. The Commission concluded that AT&T could fund a greater share of its construction program with short-term debt at the prime rate and, consequently, that it would be unreasonable to burden future ratepayers with interest charges for long-term construction in excess of the prime rate.⁶ Moreover, the Commission concluded that investors are not necessarily entitled to receive the prescribed rate of return on such projects until they are placed in service.⁷

5. In 1978 in Docket 21230⁸ the Commission amended the USOA to accommodate the Docket 19129 ratemaking decisions. It divided the plant under construction account into a short-term subdivision and a long-term subdivision.⁹ The Commission did not specify an accrual rate for AFUDC for accounting purposes.

6. In 1985 the Commission revisited the accounting for AFUDC in Docket 84-469.¹⁰ In that proceeding the Commission established a policy to adopt generally accepted accounting principles (GAAP) in the USOA to the extent possible consistent with regulatory needs. In implementing that policy the Commission considered, but did not adopt, the GAAP standard for capitalization of AFUDC. The GAAP standard essentially requires that AFUDC be accrued at a rate based on the actual cost of debt.¹¹ The Commission decided not to adopt GAAP with respect to this issue because the prime rate prescribed by the Commission for ratemaking and the actual cost of debt required under GAAP were not materially different.

7. Thereafter, Illinois Bell, an Ameritech subsidiary, attempted to raise the AFUDC issue in the Docket 86-497 rate base proceeding.¹² On reconsideration in that Docket, Illinois Bell objected to the use of the prime rate for ratemaking, but the Commission declined to address the matter on the merits because the matter was not properly before it.¹³ Illinois Bell subsequently appealed this ruling to the United States Court of Appeals for the District of Columbia Circuit along with other rate base issues. The court found that the Commission was on solid ground in refusing to expand the scope of its proceeding and advised

Illinois Bell that it should petition the Commission in the usual manner if it wanted the AFUDC rationale reconsidered.¹⁴

III. PETITION SUMMARY, COMMENTS AND REPLIES

8. Ameritech proposes that we modify the accounting requirements for AFUDC in Section 32.2000(c)(2)(x) of our Rules, to specify that the AFUDC rate for a local exchange carrier shall be the prescribed rate of return last authorized for that carrier by the Commission. In addition, Ameritech requests that we modify Section 65.820(a) of our Rules to specify that the AFUDC for assets included in the rate base and summarized in Account 2001, Telecommunications Plant in Service, shall be computed in accordance with Section 32.2000(c)(2)(x). In effect these changes would set the rate for AFUDC capitalization on long-term construction for both accounting and ratemaking at the Commission authorized rate of return.

9. Ameritech claims that the requested amendments are necessary to resolve several inconsistencies in our Rules. First, Ameritech claims that circumstances have changed since 1977 and that construction is not financed through short-term borrowing at the prime rate alone, but through a combination of debt and equity. Considering this, Ameritech claims that AFUDC accrued at the prime rate is below the cost of funds used for construction.¹⁵ Second, Ameritech observes that to the extent that short-term borrowings may be used to fund construction projects, these funds and the associated interest cost are also reflected in the capital structure and debt cost used by the Commission in prescribing the overall rate of return.¹⁶ Third, Ameritech contends that the use of the prime rate is inconsistent with the Commission's policy of encouraging carriers to invest in the telecommunications infrastructure. Ameritech asserts that if greater returns can be earned elsewhere, there is little incentive to reinvest internally generated funds in the regulated business.¹⁷

10. In opposition, MCI contends that Ameritech's proposal is unnecessary and in conflict with the Commission's policy. MCI claims that the Commission has repeatedly required "reasonable interest" as the appropriate bench-

⁶ Docket 19129 at 59.

⁷ Docket 19129 at 60.

⁸ In the Matter of Amendment of Part 31, Uniform System of Accounts for Class A and Class B Telephone Companies, *Report and Order*, 68 FCC 2d 902 (1978) (*Amendment of Part 31*). (The USOA in Part 31 was replaced by the USOA in Part 32 effective January 1, 1988.)

⁹ This division is continued under the new USOA in Part 32 as separate accounts: Account 2003, Telecommunications Plant under Construction-Short Term, and Account 2004, Telecommunications Plant under Construction-Long Term.

¹⁰ In the Matter of Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles (Parts 31, 33, 42, and 43 of the FCC's Rules), *Report and Order*, 102 FCC 2d 964 (1985) at 44-47 and 90-92.

¹¹ Statement of Financial Accounting Standards No. 34 (SFAS 34), Capitalization of Interest Cost, states: "If an enterprise's financing plans associate a specific new borrowing with a qualifying asset, the enterprise may use the rate on that borrowing.... If average accumulated expenditures for the asset exceed the amounts of specific new borrowings associated with the asset, the capitalization rate to be applied to such excess shall be a weighted average of the rates applicable to other borrowings of

the enterprise." Under GAAP, an enterprise's current accrual for AFUDC cannot exceed the total amount of interest cost it incurs in the period.

¹² Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, *Report and Order*, 3 FCC Rcd 269 (1987), *recon.*, 4 FCC Rcd 1697 (1989) (*Rate Base Reconsideration Order*), *remand sub nom.*, Illinois Bell Tel Co v. FCC, 911 F.2d 776 (1990) (*Illinois Bell*), *Decision on Remand*, 7 FCC Rcd 296 (1991).

¹³ *Rate Base Reconsideration Order*, 4 FCC Rcd at 1703.

¹⁴ *Illinois Bell*, 911 F.2d at 782-83.

¹⁵ Ameritech Petition, pp. 6-8.

¹⁶ Ameritech Petition, p. 8. Agreeing with Ameritech on this point, BellSouth contends that this constitutes a flaw in the Commission's Docket 19129 decision because the Commission, in assuming that the same short-term borrowings used for funding construction are also available to fund other corporate operations, double counts the effect of low-cost, short-term debt—once in applying it to AFUDC and a second time in applying it to the funding of operations. See, BellSouth Comments, pp. 2-3.

¹⁷ Ameritech Petition, pp. 9-10, citing *Bessemer & Lake Erie R.R. Co. v. ICC*, 691 F.2d 1104, 1111 (3rd Cir. 1982).

mark and that Ameritech's analysis of the actual source of funding is irrelevant to a determination of a reasonable interest rate.¹⁸ With respect to the allegation that short-term financing is counted twice, MCI responds that the Commission specifically considered the impact of short-term financing for construction by the telephone companies and found that short-term financing could be increased to finance a larger portion of construction without changing the overall cost of capital. MCI claims, therefore, that the Commission specifically considered the issue and found that the adjustment recommended by BellSouth was simply unnecessary because of the *de minimis* impact on the overall cost of capital.¹⁹ As for Ameritech's claim that AFUDC at the prime rate does not provide adequate incentive for infrastructure development, MCI observes that Ameritech did not indicate that it was having difficulty attracting investors or funding long-term construction under the current provisions and that, to the contrary, Ameritech's long-term construction exceeded \$2 billion over the last few years. Further, MCI contends that the Commission effectively considered the incentive issue in Docket 19129 and recognized that the use of the prime rate encourages companies to complete construction as expeditiously as possible.²⁰

11. To support its claim that the Commission-authorized rate of return should be used for AFUDC, Ameritech observes that the Commission has stated that the rationale for AFUDC is "to compensate investors for the full cost of construction."²¹ Ameritech states further that at least one court has agreed that "AFUDC is intended to compensate investors for the use of their funds during construction."²² Ameritech claims that the full cost includes the cost of capital incurred by the telephone companies to finance construction projects. Thus, Ameritech contends, since the Commission and the courts have articulated that AFUDC accrual is intended to allow investors to recover the full cost of construction, the use of the prime rate is inconsistent with the articulated rationale. In light of how financing is actually being done, it contends, the overall rate of return is the rate that should be used for AFUDC accrual.²³ MCI counters that Commission statements for "full cost" compensation are taken out of context.²⁴ At the same time, MCI claims, Ameritech ignores the Commission's direct statements on the matter in the Docket 19129 proceeding where "reasonable interest" was established as the appropriate benchmark for AFUDC accrual.²⁵

12. In its response to Ameritech, NYNEX argues that a standard consistent with GAAP would be appropriate for both Commission ratemaking and accounting purposes. NYNEX says this can be accomplished by (1) requiring accrual of AFUDC on long-term construction at a carrier's cost of debt, (2) including plant under construction long-term in the rate base, and (3) including the capitalized AFUDC as interest income in the determination of earnings. This treatment, contends NYNEX, provides an appro-

priate balance between cost recovery and ratepayer interests, and it is consistent with the Commission's policy to adopt GAAP wherever possible.²⁶

IV. DISCUSSION

13. Considering Ameritech's petition and the comments thereon, we have tentatively decided that amendment of our accounting and ratemaking rules related to AFUDC is in order.

14. Ameritech's petition claims that our current requirement that AFUDC be computed at the prime rate for ratemaking purposes is unfair to investors. It proposes that AFUDC be computed at the authorized rate of return. NYNEX notes, on the other hand, that the Ameritech proposal to compute AFUDC using the rate of return would be inconsistent with GAAP which specifies that AFUDC be computed using the cost of debt. NYNEX points out that in Docket 84-469 the Commission adopted a policy of adopting GAAP in the accounting rules to the extent possible consistent with regulatory needs. NYNEX further states that, through use of the Revenue Requirement Offset Method, it is possible to achieve the fairness to investors sought by Ameritech and the adoption of GAAP consistent with the Commission's general accounting policy.

15. Consistent with the policy set in Docket 84-469, we prefer the use of GAAP in our accounting rules. We prefer also that our ratemaking requirements be consistent with our accounting rules. Such conformity will enhance the utility of the data reported for regulatory purposes. Further, a single method that is consistent with GAAP can be expected to simplify accounting and reduce carrier record-keeping and reporting burdens associated with this issue.

16. Toward this end, NYNEX proposed use of the Revenue Requirement Offset Method for long-term construction. As proposed by NYNEX, AFUDC would be capitalized on long-term construction at the cost of debt and the amount capitalized during any period would be recognized as income and would be an offset to the revenue requirement for that period. NYNEX, however, proposes capitalization of AFUDC at the cost of debt for long-term construction only; NYNEX did not propose any change for the short-term portion. But, under GAAP there is no long-term/short-term distinction, and the changes proposed by NYNEX, therefore, would not provide an AFUDC capitalization methodology that is fully consistent with GAAP.

17. In the interest of attaining full adoption of GAAP for AFUDC capitalization, we modify the NYNEX proposal. In this notice we propose changes to our Rules that would require the use of the Revenue Requirement Offset Method for both long-term and short-term construction and that would provide for interest capitalization according to the GAAP requirements, as stated in SFAS 34 and its amendments.²⁷ In the Appendix to this notice we propose the

¹⁸ MCI Comments, pp. 5-7; MCI Reply, p. 2.

¹⁹ MCI Reply, pp. 2-3.

²⁰ MCI Comments, p. 8; MCI Reply, p. 3.

²¹ Ameritech Petition, p. 9, citing *Rate Base Reconsideration Order*, 4 FCC Rcd at 1703.

²² Ameritech Petition, p. 9, citing *Illinois Bell*, 911 F.2d at 782.

²³ Ameritech Petition, pp. 8-9.

²⁴ MCI states that the Commission statement was taken from a

Commission brief to the court on *Illinois Bell*, and that issue was not properly before the court.

²⁵ MCI Comments, p. 7.

²⁶ NYNEX Comments, pp. 4-6; NYNEX Reply, pp. 2-3.

²⁷ SFAS 34 has been amended by SFAS 42, Determining Materiality for Capitalization of Interest Cost; SFAS 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method; and

following: (1) elimination of the long-term/short-term dichotomy for plant under construction, (2) capitalization of AFUDC at the cost of debt on all construction, (3) inclusion of all plant under construction in the rate base, and (4) application of the amount of AFUDC capitalized as a revenue requirement reduction for the period it is capitalized.

V. CONCLUSION

18. Upon consideration of the Ameritech petition and comments thereon, we propose to amend Parts 32 and 65 of our Rules. In this notice we seek comments on the proposed amendments as set forth in the Appendix as well as on alternative amendments. In conjunction with this, we delegate authority to the Chief, Common Carrier Bureau to request and obtain from the Regional Bell Operating Companies any data necessary to evaluate the possible revenue requirement impact of the proposed changes.

VI. PROCEDURAL MATTERS

19. *Ex Parte Rules - Non Restricted Proceeding.* This is a non-restricted notice and comment rulemaking proceeding. *Ex parte* presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in Commission Rules. See generally 47 C.F.R. Sections 1.1202, 1.1203, and 1.106(a).

20. *Regulatory Flexibility Act.* We certify that the Regulatory Flexibility Act of 1980 does not apply to this rulemaking proceeding because if the proposed rule amendments are promulgated, there will not be a significant economic impact on a substantial number of small business entities, as defined by Section 601(3) of the Regulatory Flexibility Act. Carriers providing interstate services affected by the proposed rule amendment generally are large corporations or affiliates of such corporations. The Secretary shall send a copy of this NPRM, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with paragraph 603(a) of the Regulatory Flexibility Act. Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. Section 601 *et seq* (1981).

21. *Comment dates.* Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's Rules, 47 C.F.R. Sections 1.414 and 1.419, interested parties may file comments on or before May 13, 1993, and reply comments on or before May 28, 1993. To file formally in this proceeding, you must file an original and five copies of all comments, reply comments, and supporting comments. If you want each Commissioner to receive a personal copy of your comments, you must file an original and nine copies. You should send comments and reply comments to Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554. Comments and reply comments will be available for public inspection during regular business hours in the Dockets Reference Room of the Federal Communications Commission, 1919 M Street, N.W., Washington, D. C. 20554.

22. For further information on this proceeding, contact the Accounting Systems Branch, Accounting and Audits Division, F.C.C., Room 812, 2000 L St., N.W., Washington, D.C. 20554, (202)-634-1861.

23. Authority for issuance of this NPRM is contained in Sections 4(i), 201-205, 219, and 220 of the Communications Act of 1934, as amended, 47 U.S.C. Sections 154(i), 201-205, 219, and 220.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Donna R. Searcy *WTC*
Secretary

APPENDIX

47 CFR, Parts 32 and 65 are proposed to be amended as follows:

Part 32 - Uniform System of Accounts for Telecommunications Companies

1. The authority citation for Part 32 continues to read as follows:

Authority: secs. 4(i), 4(j) and 220 as amended; 47 U.S.C. 154(i), 154(j) and 220 unless otherwise noted.

2. Paragraph 32.2000(c)(2)(x) is revised to read as follows:

§ 32.2000 Instructions for telecommunications plant accounts.

(c) ***

(2) ***

(x) "Capitalized interest cost" includes the cost of funds used during construction. Capitalized interest cost shall be charged to assets in Account 2003, Telecommunications Plant Under Construction, and, if appropriate under generally accepted accounting principles, on suspended construction projects reclassified to Account 2006 (as provided in §32.2003(c)) as follows: If financing plans associate a specific new borrowing with an asset, the rate on that borrowing may be used for the asset; if no specific new borrowing is associated with an asset or if the average accumulated expenditures for the asset exceed the amounts of specific new borrowings associated with it, the capitalization rate to be applied to such excess shall be a weighted average of the rates applicable to other borrowings of the enterprise. The amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred

SFAS 62, Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants. In addition, other releases from the Financial Accounting Stan-

dards Board have included guidance on the capitalization of interest.

by the company in that period. Such amounts included in the cost of construction shall be credited to Account 7340, Interest Cost Capitalized.

3. Section 32.2003 is amended by revising the section heading and paragraphs (a) and (c) to read as follows:

§ 32.2003 Telecommunications plant under construction.

(a) This account shall include the original cost of construction projects. (Note also §32.2000(c).)

(c) If a construction project has been suspended for six months or more, the cost of the project included in this account shall be transferred to Account 2006, Nonoperating Plant, without further direction or approval of this Commission. If a project is abandoned, the cost included in this account shall be charged to Account 7370, Special Charges.

4. Section 32.2004 is removed.

5. Section 32.7340 is revised in its entirety to read as follows:

§ 32.7340 Interest cost capitalized.

This account shall be credited with such amounts that are charged to plant accounts for the purpose of capitalizing interest cost. (See §32.2000(c)(2)(x).)

Part 65 -- Interstate Rate of Return Prescription Procedures and Methodologies

1. The authority citation for Part 65 continues to read as follows:

Authority: Secs. 4, 201, 202, 203, 205, 218, 403, 48 Stat., 1066, 1072, 1077, 1094, as amended, 47 U.S.C. 154, 201, 202, 203, 205, 218, 403.

2. Section 65.450(d) is revised to read as follows:

§ 65.450 Net Income.

(d) Except for interest cost capitalized, reasonable charitable deductions and interest related to customer deposits, the amounts recorded as nonoperating income and expenses and taxes (Accounts 7300-7450) and interest and related items (Accounts 7500-7540) and extraordinary items (Accounts 7600-7640) shall not be included unless this Commission specifically determines that particular items recorded in those accounts shall be included.

3. Section 65.820(a) is revised to read as follows:

§ 65.820 Included items.

(a) *Telecommunications Plant.* The interstate portion of all assets summarized in Account 2001 (Telecommunications Plant in Service) and Account 2002 (Property Held for Future Use), net of accumulated depreciation and amortization, and Account 2003 (Telecommunications Plant Under Construction), and, to the extent such inclusions are allowed by this Commission, Account 2005 (Telecommunications Plant Adjustment), net of accumulated amortization. Any interest cost for funds used during construction capitalized on assets recorded in these accounts shall be computed in accordance with the procedures in §32.2000(c)(2)(x).
